In the Supreme Court of the United States

OCTOBER TERM, 1973

No. 72-1585

HOOVER, INC., PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

MEMORANDUM FOR THE RESPONDENT IN OPPOSITION

The United States Tax Court held (Pet. App. C) that petitioner was not entitled to bad debt and interest deductions claimed under Sections 162, 163, 165 and 166 of the Internal Revenue Code of 1954, 26 U.S.C. 162, 163, 165 and 166. The court of appeals affirmed by order (Pet. App. A). Underlying all petitioner's contentions here is its assertion that the Tax Court erred in finding that petitioner made certain payments only as a conduit and not on its own behalf.

1. Petitioner is engaged in quarrying and selling limestone and related products used in building highways. Its sole shareholder is E. H. Hoover, Jr., who is also the sole shareholder of Hot Mix, Inc., a general contractor supplying paving materials and services used for road and highway construction. During the years

in question, Hot Mix had several wholly-owned subsidiaries, one of which was John L. Burns, Inc. ("Burns, Inc."), a general contractor in road grading and highway construction (Pet. App. A-7 to A-8). These corporations participated as a team in bidding on and participating in highway contracts (Pet. App. A-10 to A-11).

Fidelity & Casualty Company of New York ("Fidelity") guaranteed an $800,000 line of credit for Burns, Inc. and Hot Mix with the Commerce Union Bank of Nashville ("Bank"). E. H. Hoover, Jr., another individual, Hot Mix, and its wholly-owned subsidiaries, together executed a guaranty of repayment to the Bank of loans made under that line of credit. Petitioner was not a party to the guaranty agreement (Pet. App. A-11 to A-13).

Subsequently, Burns, Inc. and Hot Mix, as principals, and petitioner, as indemnitor, entered into a "general contract of indemnity" in which they agreed to indemnify Fidelity against any loss resulting from liability on any surety bond Fidelity might sustain on behalf of either of the principals (Pet. App. A-13). Hoover individually also pledged and assigned to Fidelity, as additional security, certain funds which were to be held in escrow (Pet. App. A-13 to A-14).

Burns, Inc. borrowed $700,000 from the Bank under the line of credit and, as of December 1, 1966, $594,000 remained due and payable. On that date, Fidelity demanded payment from Hoover personally. Hoover had already deposited with Fidelity sufficient collateral in cash and government securities, which Fidelity liquidated in accordance with Hoover's instructions.

Fidelity did not, however, apply the proceeds directly to the payment of the debt to the Bank. Instead, pursuant to an agreement between Hoover and Fidelity, the proceeds of the liquidated collateral were returned to Hoover in exchange for Hoover's effectuation of the following series of transactions: Hoover gave petitioner a check for $594,000, receiving in return a five percent demand promissory note in the same amount; petitioner gave Burns, Inc. a certified check for $594,000 and received in return another five percent demand promissory note for the same amount; and Burns, Inc. paid the Bank the $594,000 due, thus releasing Fidelity from any obligation. Burns, Inc was not then or subsequently in a position to repay the funds advanced to it through petitioner (Pet. App. A-15 to A-19).

On December 31, 1966, petitioner charged off on its books as a bad debt $557,746.07 (representing the balance due on the $594,000 advance after crediting Burns, Inc. with the transfer to petitioner of its fixed assets) (Pet. App. A-19 to A-20). Petitioner's 1966 return claimed $557,746.07 as a bad debt deduction under Section 166 of the Internal Revenue Code of 1954, 26 U.S.C. 166. In the Tax Court and the court of appeals, petitioner claimed a deduction for this amount as an ordinary and necessary business expense under Section 162 or, alternatively, as a business loss under Section 165. The courts held that petitioner had acted merely as a conduit through which Hoover satisfied his guaranty obligation; that no debtor-creditor relationship existed in fact between petitioner and Burns, Inc. or between petitioner and Mr. Hoover; and, therefore, that petitioner was not entitled to any deduction on account of the transaction.

2. The essentially factual determinations by the Tax Court were upheld by the court of appeals as not clearly erroneous, and they warrant no further review.

It is well established that tax consequences turn on the economic substance rather than the form of the transaction. *Knetsch* v. *United States*, 364 U.S. 361; *Commissioner* v. *Court Holding Co.*, 324 U.S. 331; *Higgins* v. *Smith*, 308 U.S. 473; *Gregory* v. *Helvering*, 293 U.S. 465. As this Court noted in *Court Holding Co.* (324 U.S. at 334):

> [A] transaction must be viewed as a whole * * *. A [payment] by one person cannot be transformed for tax purposes into a [payment] by another by using the latter as a conduit through which to pass [funds]. To permit the true nature of a transaction to be disguised by mere formalisms, which exist solely to alter tax liabilities, would seriously impair the effective administration of the tax policies of Congress.

Here, the substance of the transaction was Hoover's payment of his guaranty obligation out of funds held by Fidelity. The series of exchanges of checks and notes by which Fidelity permitted this to be accomplished added nothing of substance to the basic transaction.[1]

The Tax Court properly looked at the substance of the transaction in holding that petitioner acted as a

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[1]The series of transactions was barren of any business purpose, but it did have substantial tax purposes. Hoover was seeking to convert a capital loss in his own hands into an ordinary business loss for one of his corporations. At the same time, the note issued by petitioner to Hoover could have been used to characterize subsequent withdrawals of funds by Hoover as loan repayments rather than as dividends, thereby avoiding their taxation as income to Hoover.

mere conduit. Petitioner challenges (Pet. 12-20) the correctness of that holding, contending that the courts "looked to an isolated part of, rather than to the overall import of the entire transaction * * *" (Pet. 16). But the Tax Court's holding was based upon the overall import of the transaction, which the court concluded was nothing more than a device for Hoover's personal payment. This resolution by the Tax Court of a particular factual question creates no conflict among the courts of appeals.

Petitioner additionally contends (Pet. 8-12) that the courts below erred in not permitting a loss deduction under Section 165. Only losses actually sustained are deductible, however, and, as the Tax Court correctly found, petitioner as a mere conduit suffered no loss.

It is therefore respectfully submitted that the petition for a writ of certiorari should be denied.

ROBERT H. BORK,
Solicitor General.

JULY 1973.